CREDIT UNION AMENDMENT ACT

A Discussion Paper

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British Columbia

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and Corporate Relations

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MESSAGE FROM THE MINISTER:

An important component of our government's plan to diversify the British Columbia economy is financial sector development.

Release of this discussion paper fulfills a commitment made in my budget speech of March 19, 1987. At that time, I announced that our government would advance its plan to support financial sector development by modernizing legislation and promoting health and stability of financial institutions.

British Columbia's credit union system is — and will continue to be — a strong force in the provincial economy. The policy proposals outlined in this discussion paper plot a course for the future development of a system which, to its credit, is ever striving to improve the range and level of services it offers to thousands and thousands of customers.

I look forward to receiving input on issues raised in this discussion paper from members of the system and all other interested parties.

Yours truly,

Mel Couvelier
Minister

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1. Introduction

The credit union system in British Columbia is one of the strongest in Canada. With total assets of $6.7 billion and a membership of nearly one million, credit unions play an important role in the British Columbia economy. For over 50 years, credit unions have been providing financial services to their members and communities.

Credit unions, with their highly committed membership, have remained a strong force in the British Columbia financial sector despite increasing competition and a relatively weak economy. There has never been a credit union failure in British Columbia which resulted in deposit insurance claims.

However, in view of the major changes to the regulation of financial institutions being implemented throughout Canada, it is appropriate to review credit union regulation as well.

The Government of British Columbia envisages a number of changes to modernize legislation and to promote financial health of the credit union movement. The objective is to allow the credit union system to play a more active role in economic development of the province. Specifically, the changes will have the following objectives.

- to enhance depositor confidence in credit unions;
- to ensure government's relationship with the credit union system provides regulation, stabilization, liquidity and deposit insurance to credit unions in an efficient manner;
- to facilitate improvement of the capital base of credit unions;
- to accommodate increased credit union involvement in economic development;
- to ensure adequate liquidity reserves are available for the system;
- to assist credit unions in further refining corporate governance;
- to maintain credit union solvency and avoid losses or failure; and,
- to enable the British Columbia credit union system to compete effectively with other financial institutions.

The purpose of this document is to discuss major policies the government intends to implement through revisions to the *Credit Union Act* and regulations. These intentions are now being publicly announced to give the credit union movement and other interested parties an opportunity to make representations prior to introduction of legislation in the next session of the Legislature.

2. Deposit Insurance

Deposits and non-equity shares in credit unions are insured by the Credit Union Deposit Insurance Corporation of British Columbia (CUDIC). CUDIC maintains a deposit insurance fund; a self-insurance vehicle which depends on the success of credit unions to ensure depositors are protected. This dependency has caused concern in some quarters about the adequacy of deposit insurance.

Recent bank and trust company failures and financial difficulties of the credit union system in Alberta have also contributed to some depositor unease with respect to smaller regional institutions.

While the provincial government has the authority to lend money to CUDIC, there is no formal lending arrangement in place. Because there is no formal provincial government support for CUDIC, some depositors have expressed concern about security of credit union deposits. The government believes this issue must be satisfactorily resolved if credit unions are to remain competitive.

- The government intends to implement a formal arrangement through which it will provide financial support for credit union deposit insurance on terms and conditions which provide adequate protection to both depositors and taxpayers. Any provincial government assistance will be in the form of loans which must, over a reasonable period, be repaid by the system. The government intends that its financial support provide a base guarantee, with provincially-backed insurance coverage limited to a specific amount for each type of account held by each depositor in each credit union. This is similar to coverage provided by the Canada Deposit Insurance Corporation (CDIC).

  The deposit insurance currently offered by the credit union system will remain in effect until modified by the system. However, insurance in excess of the limit must not place additional obligations on the provincial government.

Details of a modified deposit insurance scheme will be developed with the credit union system over the coming months.

3. Government's Role in the Credit Union System

The Superintendent of Credit Unions is responsible for incorporation, regulation and regular inspection of credit unions.

British Columbia Central Credit Union provides liquidity and clearing services for the credit union system.

CUDIC provides deposit insurance and stabilization or revitalization. (Revitalization involves remedial measures including supervision of management, provision of financial assistance and facilitating mergers to help credit unions overcome financial difficulties).

This organization of responsibilities is not without its problems. Some responsibilities overlap and result in inefficiencies.

One example is inspection services. The superintendent annually inspects for statutory compliance. But, where a credit union is under supervision of CUDIC, the superintendent is deemed to have delegated his inspection power.

At the same time, the quality of service that credit unions receive has been questioned. The superintendent focuses on statutory compliance, while CUDIC is concerned with risks to the deposit insurance fund. Early warning and monitoring systems, credit union development and risk management for those not under supervision, understandably receive less attention. This may partly explain the recent increase in the number of credit unions subject to CUDIC's formal stabilization procedures.

B.C. Central Credit Union has inaugurated an examination program to help avoid or relieve financial difficulties before they become serious. Although there is a need and demand for such a program, it does add a third, overlapping inspection function.

One, uniform, high quality inspection program which provides sufficient information to test compliance, to allow for early warning and development and to allow stabilization and deposit insurance decisions to be made would be less costly, reduce the number of credit unions brought under supervision and be in the interest of the entire credit union system. Specific areas which need to receive greater emphasis include loan evaluation and monitoring and asset/liability management.

Another example of overlap is regulation. The superintendent regulates credit unions in the public interest. CUDIC becomes a quasi-regulator when credit unions come under its supervision.

Credit unions have long requested greater self-regulation in areas such as approval of business loans. Currently, CUDIC approves business loans regardless of the security available. Delay and uncertainty associated with this process may cause credit unions to lose commercial business to competing financial institutions. Nevertheless, risks associated with these loans must be accurately assessed to protect the credit union system.

- The government intends to minimize conflicts and inefficiencies and to improve service to credit unions based on the principle of a single, high quality inspection program. This may be accomplished by combining CUDIC and the Office of the Superintendent of Financial Institutions into a single provincial agency. This agency could be responsible for making deposit insurance available to all provincial deposit-taking institutions. It could also undertake the revitalization function for credit unions and the regulatory function for all other provincial financial institutions.

4. Capital

Most credit unions are under-capitalized. By statute, credit unions are required to maintain capital equal to five per cent of assets. Capital includes the amount paid for equity shares by members and retained earnings.

The average credit union in British Columbia has 1.5 per cent of assets in capital. In an effort to provide a transitional period during which capital can be rebuilt, regulations under the *Credit Union Act* set goals of 2.4 per cent by the end of 1987 and 3.0 per cent by the end of 1990. Without a system-wide plan to increase capital, statutory limits and benchmarks will have little effect. The importance of adequate capital reserves cannot be overstated. Capital provides a necessary buffer to absorb losses, thereby reducing the risk of failure. A strong capital base is also a prerequisite for growth since it provides operating flexibility necessary for competitive pricing and for development or expansion of services.

Two traditional methods of increasing capital reserves for credit unions are to reduce dividends as a strategy to increase retained earnings and to sell equity shares to members.

In the near term, it seems unlikely credit unions will be able to increase their profit margins enough to substantially improve retained earnings. Nevertheless, credit unions should be encouraged to limit distribution of dividends until a satisfactory level of capital is achieved. This could be accomplished by linking either deposit insurance premiums, investment and lending powers or the ability to expand to the credit union's capital base.

Many credit unions have voluntarily implemented programs requiring members to purchase equity shares in their credit union. While the results have been encouraging, there is a need to explore further sources of capital for credit unions.

Some suggested alternatives are:

- to require all members in the credit union system to purchase equity shares;
- to create a credit union mutual fund;
- to offer shares to the public through subsidiaries; and,
- to offer credit union equity shares as RRSP investments.

Other mechanisms for increasing capital may be available.

Currently, attempts by credit unions to raise capital are initiated randomly. There is no system-wide organization. Efforts could be more focused and productive if a system-wide plan for increasing credit union equity were developed and initiated.

- The government intends to include enabling provisions in the *Credit Union Act* to ensure a variety of alternative methods are available to credit unions to raise capital. Methods could include those described above or others suggested in response to this paper.
- The government intends to establish incentives for credit unions to increase capital, possibly including deposit insurance premium discounts, increased investment and lending powers and the ability to expand.
- The government also intends to require that credit unions develop a system-wide plan, approved by the board of B.C. Central Credit Union and reviewed annually, for increasing capital.

5. Regionalization

While the government will not impose regional structures or organizations on the credit union system, it wishes to encourage efficiencies which could be gained by some forms of regional co-operation.

Credit unions have requested autonomy in approval of business loans although in some cases, expertise for assessing commercial risk is not available to individual credit unions. It may be possible to combine resources of several credit unions, including the services of business loan experts, to develop regional commercial loans offices. These offices could be coupled with a commercial loan subsidiary, owned by the credit unions but with additional capital from the public, to ensure adequate support for loans.

Many other opportunities for regional co-operation exist. A regional subsidiary could be formed to provide certain shared services which individual credit unions cannot afford to undertake alone. This could include services to the public, such as insurance or travel, and services to credit unions such as computing or internal audit.

Regional structures involving credit unions might also be a useful delivery mechanism for local economic development programs.

- The government intends to amend the *Credit Union Act* to facilitate regional co-operation among credit unions for their mutual benefit and the benefit of their local economy.

6. Adapting to Change

In order to allow credit unions to participate fully in new financial markets, government proposes to provide additional mechanisms for credit unions to adapt to changing circumstances.

One traditional mechanism which has been used by credit unions to adapt to change is mergers or amalgamations. This has prevented credit union failures and resulted in stronger, more competitive credit unions in many cases. However, requirements for approval of mergers and amalgamations are strict and, in some cases, prevent advantageous mergers from being completed. Mergers could be facilitated by reducing the percentage of members' votes required for approval.

Another mechanism that is consistent with new capabilities of other financial institutions would be to allow credit unions — either individually, in groups or centrally — to own trust companies, insurance companies and securities dealers. Although credit unions cannot do business outside the province, subsidiary firms would not necessarily be limited to British Columbia markets.

Some credit unions may outgrow their traditional market and require a financial structure which is less restricted by geography or financial considerations. A trust company, for example, has power to operate outside the province to take advantage of larger markets. Trust companies also have greater ability to raise capital. The government proposes to make provision in the *Credit Union Act* and *Trust Company Act* to allow a credit union to convert to a trust company provided there is very substantial membership support.

- The government intends to facilitate amalgamations and mergers of credit unions which clearly have membership support; allow credit unions to own trust companies, insurance companies and securities dealers where appropriate, and to allow credit unions to convert to trust companies where there is very substantial membership support.

7. Liquidity

Adequate liquidity for the individual credit union and the system as a whole is essential. Liquidity is the ability of an organization to meet its financial obligations as they become due. Appropriate levels of liquidity are crucial to the maintenance of depositor confidence.

Adequate liquidity in the British Columbia system is ensured through two requirements. One is the statutory liquidity requirement that an amount equal to 10 per cent of liabilities be maintained in certain demand and term deposits and investments in government bonds and debentures or in British Columbia Central Credit Union. The second is a requirement that one per cent of liabilities be maintained in cash to meet normal and emergency cash needs.

Most but not all statutory liquidity reserves in British Columbia are maintained at B.C. Central Credit Union.

- The government intends to require that every credit union, whether it is a member of B.C. Central Credit Union or not, maintain liquidity equal to 10 per cent of its liabilities in B.C. Central Credit Union. B.C. Central Credit Union will be subject to inspection by the superintendent to ensure an adequate return on the liquidity.

8. Corporate Governance

Primary responsibility for the health of the credit union system lies with boards of directors of individual credit unions and their management teams. Recently, measures have been proposed by other provinces and by the federal government to improve corporate governance in financial institutions. In the interest of encouraging credit unions to continue improving internal governance and maintaining comparable standards of corporate governance across various types of financial institutions, the areas described below will be addressed.

Directors

The board of directors of a credit union is directly responsible for guiding credit union management. Increasingly this responsibility requires that directors of credit unions have some degree of knowledge and experience in the complexities of managing a modern financial institution.

Therefore, a mandatory training program delivered by B.C. Central Credit Union is proposed for directors of credit unions. The program would be based on the one already being developed by B.C. Central Credit Union. It would also have to be readily accessible to credit unions throughout the province. Details — including duration, level of complexity and administration — will be developed with the credit union system.

- The government intends to require that all credit union directors complete a B.C. Central Credit Union training course unless exempted by the superintendent due to background or experience.

New legislation will also clarify director liability for actions of the credit union by applying standards comparable to other financial institutions legislation and more onerous than those presently applied to credit union directors.

- The government intends to require a higher standard of care for credit union directors in exercising their duties. Directors will be required to exercise the care that a prudent director of a financial institution would reasonably be expected to exercise in the circumstances.

Professional directors are individuals appointed directly by the board who have particular experience or expertise in operating credit unions. Professional directors have all the powers and responsibilities of a member of a credit union board.

- The government intends to allow credit union boards to appoint up to three professional directors with the approval of the superintendent once an appropriate bylaw has been enacted by the credit union.

A credit union is based on the spirit of democracy. It, therefore, seems appropriate that credit union members should be able to vote in credit union elections even if they are unable to attend annual general meetings.

- The government intends to introduce amendments which would require credit unions to accept some form of absentee votes from members for the election of directors and for special resolutions.

- The government intends to require each credit union to have at least two committees of its board of directors:
  - — a finance committee which will be required to develop a prudent investment and lending policy, to obtain annual approval of the policy from the board of directors and to implement the policy through ongoing approval and monitoring of investments and loans; and,
  - — an audit committee which will be required to review auditor's reports, inspection reports and internal audit reports and to recommend internal financial control policies to the board.

Auditors

Auditors provide an examination of credit unions that is professional, objective and independent from other interests. Traditionally, they have been hired by credit unions and have worked directly with management. They have had little contact with credit union members or the superintendent and sometimes their communication with the board of directors is limited. The government proposes to reassess this arrangement without unduly disturbing the professional relationship the auditor must maintain with the credit union.

- The government intends to require that auditors:
  - — report to directors, and to the superintendent, matters that they discover in the course of their duties that may, in their opinion, have a material adverse effect on the credit union or that represent a contravention of the act;
  - — report on conflicts of interest;
  - — attend meetings of the audit committee and other meetings as they see fit; and,
  - — satisfy the superintendent that they are qualified to audit a credit union.

9. Investment and Lending Powers

Rules governing investments and loans should be more flexible and responsive. Under proposed new investment and lending rules, credit unions would have prescribed limits on the maximum percentage of total assets which can be invested in categories such as real estate, residential mortgages, consumer loans, commercial lending and commercial leasing. A limit on the maximum amount which can be loaned to one person as a percentage of assets will be prescribed. A minimum aggregate percentage would also be prescribed for more traditional low risk investments such as government guaranteed bonds. These specific rules will be reinforced with a general requirement that a credit union maintain a prudent investment portfolio at all times.

- The government intends to introduce revised investment rules specified in regulations under the *Credit Union Act* which will impose limits on the proportion of a credit union's assets which may be held in various categories of loans and investments to ensure that credit unions maintain prudent portfolios. Limits may vary with the level of capital in the credit union. Transition provisions will allow a reasonable period of time to comply with the revised rules.

Currently, Section 50 of the *Credit Union Act* prohibits credit unions from making guarantees. This has proved to be a handicap in attracting certain types of potentially profitable business to credit unions.

- The government intends to provide credit unions with the explicit power to guarantee obligations and the power to issue letters of credit, subject to adequate security and other conditions imposed by the superintendent or by regulation.

10. Powers of the Superintendent of Credit Unions

The ability of the superintendent to appropriately enforce compliance with the *Credit Union Act* will be enhanced.

Modern financial institutions legislation emphasizes expansion of services and participation in new financial endeavours. This new environment requires some changes to the regulator's enforcement powers to provide controls on risk and to afford him flexibility.
The government intends to make the *Credit Union Act* consistent with other financial institutions legislation in British Columbia, other provinces and Canada by providing the superintendent with the following powers:

- to examine and approve of investment and lending policies and portfolios;
- to approve of purchase or creation of credit union subsidiaries;
- to order asset valuations;
- to rule on the fitness of a proposed director as to character and competence;
- to issue cease and desist orders in the case of unsafe and unsound business practices, subject to an appeal process which will have to be completed within a reasonably short period of time; and,
- to seek court orders of enforcement.

- The government intends to provide the superintendent with modified enforcement powers in order to control risk and allow regulatory flexibility.

11. Conclusion

British Columbia credit unions play a vital role in the provincial economy. They stand alone as the one provincial financial institution providing services to all areas of British Columbia.
In summary, the government intends to bring forward legislative amendments to the *Credit Union Act* in the next session of the Legislature which will:

- provide government support for credit union deposit insurance;
- address problems related to inefficiencies inherent in the present organization of the credit union system;
- facilitate raising of capital by credit unions;
- facilitate the organization and cooperation of credit unions on a regional basis for their mutual benefit;
- establish a permanent and stable liquidity pool for credit unions;
- help credit unions continue to improve the quality of internal corporate governance;
- enhance the flexibility of investment and loan rules for credit unions; and,
- improve the enforcement powers and discretion of the Superintendent of Credit Unions.

The government invites the credit union system and interested parties to respond to issues raised in this discussion paper before September 30, 1987.

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